

1-2009

Attorneys, Accountants, and Bankers, Oh My! Primary Liability for Secondary Actors in the Wake of "Stoneridge"

Robert J. Grubb

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vlr>



Part of the [Securities Law Commons](#)

Recommended Citation

Robert J. Grubb, Attorneys, Accountants, and Bankers, Oh My! Primary Liability for Secondary Actors in the Wake of "Stoneridge", 62 *Vanderbilt Law Review* 275 (2019)

Available at: <https://scholarship.law.vanderbilt.edu/vlr/vol62/iss1/7>

This Note is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

Attorneys, Accountants, and Bankers, Oh My! Primary Liability for Secondary Actors in the Wake of *Stoneridge*

I.	BUDDY SCHWARTZ AND THE AMERICAN DREAM	276
II.	ACORNS TO OAK TREES: MISSING THE TREES FOR THE FOREST	280
A.	<i>The Creation of the Securities and Exchange Commission and its Rule 10b-5 Role</i>	280
1.	The Securities Exchange Act of 1934.....	280
2.	The Mission of the Securities and Exchange Commission.....	281
3.	Promulgation of Rule 10b-5 by the Securities and Exchange Commission	282
B.	<i>Fraud on the Market and Reliance: How Basic v. Levinson Signaled an Expansive Era for Plaintiffs' Ability to Pursue a Private Right of Action</i>	284
C.	<i>Liability for Secondary Actors: Entering the Forest</i>	285
1.	<i>Central Bank</i> and its Impact on Secondary Liability	285
2.	The Circuit Split over Rule 10b-5(b) Misrepresentation Claims.....	287
a.	<i>Bright Line Test</i>	288
b.	<i>Anixter Test</i>	289
c.	<i>Substantial Participation Test</i>	289
d.	<i>Creator Test</i>	290
3.	The Circuit Split over Rule 10b-5(a) and (c) Scheme-to-Defraud Claims.....	291
a.	<i>Principal Purpose Test</i>	292
b.	<i>Duty Test</i>	292
4.	<i>Stoneridge Investment Partners</i> and Scheme Liability.....	294

	<i>D. Congressional Responses</i>	295
III.	MOVING TOWARD A UNITARY STANDARD OF SECONDARY ACTOR LIABILITY: SCRUTINIZING THE CIRCUIT TESTS IN LIGHT OF POLICY CONSIDERATIONS	296
	<i>A. Rule 10b-5(b) Misrepresentation Claim Tests</i>	296
	1. Bright Line Test	296
	2. <i>Anixter</i> Test	298
	3. Substantial Participation Test	299
	4. Creator Test	300
	<i>B. Rule 10b-5(a) and (c) Schemes to Defraud After Stoneridge</i>	302
IV.	A UNITARY STANDARD OF LIABILITY THAT RESTORES THE AMERICAN DREAM BY CHOPPING DOWN THE FOREST. .	304
	<i>A. The Need for a Unitary Standard</i>	304
	<i>B. A Unitary Statutory Standard That Properly Protects Investors</i>	305
V.	CONCLUSION	309

I. BUDDY SCHWARTZ AND THE AMERICAN DREAM

Mervin "Buddy" Schwartz, Jr., embodied the American Dream. A Pennsylvania resident, Schwartz began working for Hershey Foods in 1961 as a maintenance mechanic.¹ He eventually became a member of the local union's executive board.² A hard worker providing for his family, Schwartz had a thirteen-year perfect attendance record and often worked overtime.³ He even managed to attend night classes and obtained an associate's degree in Bible studies.⁴

Lacking any financial training, Buddy Schwartz relied on the retirement plan and 401k⁵ Hershey provided for his retirement.⁶ Because he contributed the maximum allowable amount out of each paycheck to his 401k, he was able to retire in 1999 at the age of sixty with retirement assets worth approximately \$284,000.⁷ He rolled

1. Press Release, Ctr. for Justice & Democracy, News Conference Participants (July 31, 2007) [hereinafter Press Release] (on file with the Vanderbilt Law Review).

2. *Id.*

3. Statement of Buddy Schwartz, Ctr. For Justice & Democracy (July 31, 2007) [hereinafter Statement of Buddy Schwartz] (on file with the Vanderbilt Law Review).

4. Press Release, *supra* note 1.

5. A 401k, named after the Revenue Code section authorizing it, is a tax advantaged retirement savings plan. See I.R.C. § 401(k) (2000) (laying out the requirements and benefits of a 401(k) plan).

6. *Id.*

7. Press Release, *supra* note 1.

these assets over to Merrill Lynch so his son, James Schwartz, a financial advisor, could manage them.⁸ Not only did he retire early, but Buddy Schwartz and his wife, Louise, also were able to purchase a retirement home in Arizona to be close to family.⁹ For Buddy Schwartz, the American Dream was coming true.

This all changed, however, when James called his father in 2000 to tell him about a hot growth stock¹⁰ for a “fast-growing and stable company” called Enron.¹¹ Relying on positive Merrill Lynch analyst opinions, James advised his father to invest in Enron, which he did by purchasing about \$30,000 worth of preferred stock.¹²

Imagine Schwartz’s despair when the Enron scandal erupted in 2001, and he lost his initial investment and was forced to sell his retirement home in Arizona.¹³ Imagine his outrage when he discovered that his brokerage firm, Merrill Lynch, was lying and scheming with Enron to make its financial statements look more promising than they actually were through fraudulent transactions.¹⁴ Imagine his heartbreak when the Fifth Circuit destroyed his American dream in one stroke by failing to certify a nationwide class that would have included Schwartz and other defrauded investors. According to the court, the fraudulent actions did not give rise to primary liability under § 10(b) of the Securities Exchange Act of 1934.¹⁵

Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) prohibits the use of “any manipulative or deceptive device . . . in connection with the purchase or sale of any security.”¹⁶ In addition, the Securities and Exchange Commission (“SEC”) promulgated Rule 10b-5 to provide an enforcement action against those “employ[ing] any device, scheme, or artifice to defraud” or “engag[ing] in any act, practice, or course of business which [sic] operates or would operate as a fraud or deceit upon any person” regarding the purchase or sale of any security.¹⁷ Courts have found an

8. Statement of Buddy Schwartz, *supra* note 3.

9. *Id.*

10. Growth stocks are generally identified as stocks whose earnings are expected to grow at above average rates. These companies typically choose to reinvest their earnings into further growth, rather than distributing the profits in the form of dividends. Investopedia, Growth Stock, <http://www.investopedia.com/terms/g/growthstock.asp> (last visited Oct. 12, 2008).

11. Statement of Buddy Schwartz, *supra* note 3.

12. *Id.*; Press Release, *supra* note 1.

13. Statement of Buddy Schwartz, *supra* note 3.

14. *Id.*

15. See *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 406 (5th Cir. 2007) (declining to certify a nationwide class of investors).

16. Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (2000).

17. 17 C.F.R. § 240.10b-5(a), (c) (2008).

implied private cause of action under Rule 10b-5 that is available to private individuals like Schwartz.¹⁸ However, in the case of secondary actors such as, *inter alia*, banks, investment firms, attorneys, and accountants, the Supreme Court thus far has dismissed claims for “aiding and abetting” liability brought under either § 10(b) or Rule 10b-5.¹⁹ As a result, a plaintiff such as Schwartz who wishes to bring a claim against a secondary actor under § 10(b) must demonstrate that the secondary actor behaved in such a way as to sustain a claim for primary liability.²⁰ The Court has not clearly established what plaintiffs must demonstrate to find a secondary actor primarily liable. That question has consistently led to splits among the federal circuit courts.

Originally, claims against secondary actors were brought under Rule 10b-5(b) as misrepresentation claims.²¹ In response to these claims, the Second Circuit developed a restrictive Bright Line Test that requires a plaintiff to demonstrate that the secondary actor made a false or misleading statement or omission that can be attributed to him or her at the time of public dissemination.²² The Ninth Circuit developed an alternative standard, couched in terms of “aiders and abettors,” that finds liability where there is “(1) the existence of an independent primary wrong, (2) actual knowledge or reckless disregard by the aider and abettor of the wrong and of his or her role in furthering it, and (3) substantial assistance in the wrong.”²³ The aider or abettor need not have committed any manipulative or deceptive act, nor must the injured party have relied upon the aider or abettor’s assistance to the primary defrauder.²⁴ In addition to the Ninth Circuit’s test, the SEC has suggested its own Creator Test for secondary actor liability, but this test has only been accepted in one federal district court.²⁵ Under the Creator Test, when a person acts,

18. See *Kardon v. Nat’l Gypsum Co.*, 73 F. Supp. 798, 802 (E.D. Pa. 1947) (explaining that the Securities Exchange Act of 1934 does not define a remedy expressly even though the statute implies one).

19. See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994) (holding that § 10(b) does not allow a private right of action for aiding and abetting); see also *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) (reaffirming the lack of a private right of action for aiding and abetting).

20. *Cent. Bank of Denver*, 511 U.S. at 191.

21. See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2nd Cir. 1998) (establishing the Bright Line Test, discussed *infra* Part II.C.2.a); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 967 (C.D. Cal. 1994) (establishing the Substantial Participation Test, discussed *infra* Part II.C.2.c).

22. *Wright*, 152 F.3d at 175.

23. *ZZZZ Best.*, 864 F. Supp. at 967.

24. *Id.*

25. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 591 (S.D. Tex. 2002).

either individually or with others, with scienter²⁶ to create a misrepresentation, that person is liable as a primary violator.²⁷

As it became more difficult to prevail with a Rule 10b-5(b) misrepresentation claim, creative plaintiffs' attorneys began exploring subsections (a) and (c) of Rule 10b-5 for causes of action in relation to schemes to defraud.²⁸ The Ninth Circuit adopted the Principal Purpose Test, focusing on a secondary actor's level of involvement in a fraudulent transaction.²⁹ The Eighth Circuit offered a narrower test, only finding liability for an actor who had a duty to disclose information and did not do so.³⁰

Further complicating matters is *Stoneridge Investment Partners, LLC, v. Scientific-Atlanta, Inc.*,³¹ a case in which the Supreme Court addressed the meaning of a "deceptive act" as set forth in Rule 10b-5(c). Although the Court facially rejected the Ninth Circuit's Principal Purpose Test in favor of the Eighth Circuit's duty approach, questions still linger regarding the ability to bring scheme-to-defraud claims against secondary actors.³²

This Note attempts to discuss and analyze the evolution of Rule 10b-5 secondary actor liability and focuses on developing a singular standard that promotes certainty, efficiency, and deterrence, while adequately compensating harmed investors like Schwartz. While the compensatory function of Rule 10b-5 class action claims³³ has been questioned, this Note assumes that compensating defrauded investors is a valid objective of any Rule 10b-5 reform.³⁴

26. Scienter is a "mental state consisting in an intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY 635 (3rd Pocket ed. 2006).

27. Brief of the SEC as Amicus Curiae at 14, *Klein v. Boyd*, Fed. Sec. L. Rep. (CCH) ¶ 90,165 (3d Cir. 1998) (Nos. 97-1143; 97-1261) [hereinafter *SEC Brief*], available at <http://www.sec.gov/litigation/briefs/klein.txt>.

28. Mark S. Pincus, Note, *Circuit Split or a Matter of Semantics? The Supreme Court's Upcoming Decision on Rule 10b-5 "Scheme Liability" and its Implications for Tax Shelter Fraud Litigation*, 76 FORDHAM L. REV. 423, 448-49 (2007).

29. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006).

30. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 443 F.3d 987, 992 (8th Cir. 2006).

31. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008).

32. *In re Charter Communications, Inc., Sec. Litig.*, 443 F.3d 987, 990 (8th Cir. 2006).

33. Although investors can bring a secondary actor Rule 10b-5 claim as individuals, the reality is that most claims are brought as class actions. The reasons for this are varied, but generally litigation costs versus potential reward play a heavy role in the decision. See Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1360 (2008) (discussing how it may be uneconomical for smaller investors to bring Rule 10b-5 suits individually).

34. See, e.g., *id.* at 1313 (describing the compensatory function of Rule 10b-5 class actions as merely pocket shifting with high transaction costs).

Part II of this Note discusses the evolution of Rule 10b-5 and secondary actor liability from its beginning as an SEC tool to regulate the markets to its current status as a private right of action. Part III analyzes the various circuit tests that have developed to address secondary actor liability by highlighting their strengths and exposing their weaknesses. Part IV proposes a new unitary standard that combines the legislative spirit of § 10(b) with a proper remedy for hardworking Americans like Schwartz who may be defrauded. Its strength is its uniform application, which provides certainty and dispels the current cloud of confusion over the various secondary actor claims under Rule 10b-5. This Part also addresses various criticisms of secondary actor liability, such as the high transaction costs imposed on litigants and the potential for over-deterrence. Part V offers a few concluding remarks.

II. ACORNS TO OAK TREES: MISSING THE TREES FOR THE FOREST

Securities law can be complex considering the multitude of statutes that have developed over the years. It is easy to get lost in securities regulation, so it is helpful to trace the progression of Rule 10b-5 from its humble beginnings as an acorn, to its current status—to continue the metaphor—as a dense forest. Only then can the need for a unitary standard be fully understood.

A. The Creation of the Securities and Exchange Commission and its Rule 10b-5 Role

1. The Securities Exchange Act of 1934

Prior to 1933, there was very little federal regulation of the securities markets.³⁵ State laws, known as Blue Sky laws, were the primary regulatory force behind securities transactions.³⁶ “Black Tuesday,” the day of the stock market crash of 1929, signaled a downward spiral that ended in an 89.2 percent decline in the total

35. Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 497 (2003).

36. *Id.*

value of the stock market.³⁷ This marked the beginning of the Great Depression.³⁸

The Great Depression was a cause of major concern for Congress, the body ultimately responsible for regulating the securities markets under its legislative powers and the Commerce Clause.³⁹ In response to decreased investor confidence in American banking, business, and investment practices, which one commentator has compared to some headlines in the twenty-first century,⁴⁰ Congress enacted the Securities Exchange Act of 1934 to regulate the secondary securities exchanges and over-the-counter markets.⁴¹ The Act was promulgated to “protect interstate commerce, the national credit, the Federal [sic] taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure [sic] the maintenance of *fair and honest markets* in such transactions.”⁴² This Act, along with the Securities Act of 1933, “embrace[s] a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor.”⁴³ Realizing that effective market maintenance would require specialized knowledge, Congress delegated broad rulemaking authority under the Act to the newly created Securities and Exchange Commission.⁴⁴

2. The Mission of the Securities and Exchange Commission

The Securities and Exchange Commission is the federal agency tasked with maintaining the specialized body of knowledge necessary to regulate the securities markets.⁴⁵ Specifically, the SEC mission

37. The figure of 89.2% is measured by the drop in the Dow Jones Industrial Average from 381.17 points to 41.22 by July of 1932. See Associated Press, *It Takes a Long Time for a Market Recovery*, Oct. 13, 2008, available at <http://www.dcxaminer.com/ap/?c=y&id=920294>.

38. *Id.*

39. The Commerce Clause grants Congress the authority to “regulate Commerce . . . among the several States,” which includes interstate securities markets. U.S. CONST. art. I, § 8, cl. 3.

40. See Gary M. Brown, *Scheme Supreme: Will the Supreme Court Absolve the “Secondary Actors” Who Are the Real Culprits in Recent Corporate Scandals?* 3 (2007), available at <http://blogs.law.harvard.edu/corpgov/files/2007/10/20071015-scheme-supreme.pdf> (comparing public opinion of the finance industry during the time of the enactment of the Exchange Act to modern public opinion of the industry).

41. Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (2000).

42. *Id.* (emphasis added).

43. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)).

44. 15 U.S.C. § 78(d).

45. See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority*, 107 HARV. L. REV. 963, 964–1008 (1994) (discussing the role of the SEC in developing securities law).

statement lists its goals as “protect[ing] investors, maintain[ing] fair, orderly, and efficient markets, and facilitat[ing] capital formation.”⁴⁶ To this end, the SEC sees itself as the “Investor’s Advocate.”⁴⁷

The SEC has developed a policy that coincides with that of the Securities Acts, focusing on disclosure rather than on meritorious review of securities issues.⁴⁸ The basis for such a policy lies in the semi-strong form of the Efficient Capital Markets Hypothesis.⁴⁹ Under this theory of finance, the price of a security reflects all publicly available information about a firm.⁵⁰ As new information becomes available, it is quickly incorporated into the market price of the stock.⁵¹ This theory supports the SEC’s disclosure approach because fair public disclosure leads, in theory, to fair pricing.

3. Promulgation of Rule 10b-5 by the Securities and Exchange Commission

In 1942, the SEC sought to “close[] a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.”⁵² Previously, the Commission’s rules against fraud only applied to brokers and dealers.⁵³ The SEC thus promulgated Rule 10b-5 in order to eliminate fraud in the purchase or sale of securities by any party.⁵⁴ Rule 10b-5 broadly prohibits employing any device or scheme to defraud, making a false statement of material fact, making misleading statements due

46. U.S. Sec. & Exchange Comm., The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited Oct. 16, 2008).

47. The SEC’s self-stated mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” *Id.*

48. *Id.*

49. The three forms of the Efficient Capital Markets Hypothesis (“ECMH”) are weak, semi-strong, and strong. The weak form assumes that there is no information that can be gleaned from past price data to outperform a buy-and-hold strategy for a stock. The semi-strong form assumes that the market quickly and efficiently incorporates all known public information into the price of a stock, so the only way to beat a buy-and-hold strategy would be to have inside information. The strong form assumes that the price of a stock incorporates, quickly and efficiently, all public and non-public information about the issuer. See Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 375–81 (1984) (evaluating the three forms of the ECMH).

50. *Id.*

51. *Id.*; see also *Basic Inc. v. Levinson*, 485 U.S. 224, 253–55 (1988) (discussing the ECMH).

52. Exchange Act Release No. 3230, 7 Fed. Reg. 3804, 3804 (May 21, 1942).

53. *Id.*

54. *Id.*

to omitted material facts, or engaging in any fraudulent practice in connection with the purchase or sale of securities.⁵⁵

The reverberations of this rule have been profound.⁵⁶ What began as an enforcement mechanism at the SEC's disposal has been judicially interpreted as a private right of action for any buyer or seller of a security against any party who fraudulently induces him or her to proceed with the transaction, even if the defendant is not a direct party to the transaction.⁵⁷ Much jurisprudence has developed from this implied right; in fact, Justice William Rehnquist called the private right of action under Rule 10b-5 "a judicial oak which [sic] has grown from little more than a legislative acorn."⁵⁸ It is this judicial oak that has since splintered into the various circuit tests at issue in this Note. Before analyzing these tests, one must examine how and why the Court allowed plaintiffs to pursue class action status under Rule 10b-5.

55. Rule 10b-5 states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (2008). Interestingly, nothing in the text of the rule precludes secondary liability by limiting liability to the seller or purchaser.

56. Daniel M. Hawke, SEC Historical Soc'y, *Roundtable on Enforcement: A Brief History of the SEC's Enforcement Program 1934-1981*, at 11, (Sept. 25, 2002), available at <http://www.sechistorical.org/collection/oralHistories/roundtables/enforcement/enforcementHistory.pdf> (discussing how Rule 10b-5 allowed the SEC to prevent fraud beyond the mere broker-dealer context).

57. See *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798, 802 (E.D. Pa. 1947) (finding an implied private right of action for Rule 10b-5).

58. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

B. Fraud on the Market and Reliance: How Basic v. Levinson Signaled an Expansive Era for Plaintiffs' Ability to Pursue a Private Right of Action

The Supreme Court initially was receptive to broad arguments under Rule 10b-5. In a private federal securities action involving publicly traded securities, the elements of a Rule 10b-5 claim⁵⁹ usually include: a material misrepresentation or omission;⁶⁰ scienter;⁶¹ a connection to a purchase or sale of a security;⁶² reliance, often referred to as "transaction causation";⁶³ loss causation;⁶⁴ and economic loss.⁶⁵

In *Basic v. Levinson*, the Supreme Court opened the door to plaintiffs seeking class action certification under a Rule 10b-5 claim by creating a fraud-on-the-market presumption to establish the reliance element of the private action.⁶⁶ In *Basic*, Basic, Inc., ("Basic"), a publicly traded company, conducted merger discussions with Combustion Engineering, Inc., ("Combustion"), starting in September 1976.⁶⁷ In three separate public statements made in 1977 and 1978, Basic denied that these discussions ever took place.⁶⁸ In December 1978, Basic asked the New York Stock Exchange to suspend trading on its shares and released an announcement that it had been approached by a company to negotiate a merger.⁶⁹ Several Basic shareholders who sold their stock between the time of the first public statement that denied merger discussions and the later suspension of trading brought suit, claiming they were harmed by an artificially deflated price caused by the misleading statements.⁷⁰

59. See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005) (discussing the Rule 10b-5 elements).

60. Materiality is a fact-sensitive inquiry based on the significance a reasonable investor would place on the withheld or misrepresented information. See *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988) (discussing materiality).

61. *In re Software Toolworks Inc.*, 50 F.3d 615, 626 (9th Cir. 1994) (defining scienter as "a mental state embracing intent to deceive, manipulate, or defraud").

62. *Dura Pharm. Inc.*, 544 U.S. at 342.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Basic Inc. v. Levinson*, 485 U.S. 224, 245–47 (1988); see Mary M. Caskey, Note, *Lifting the Fog: Finding a Clear Standard of Liability for Secondary Actors under Rule 10b-5*, 41 VAL. U. L. REV. 403, 414–16 (2006) (describing the fraud on the market theory as the "most widely used method of proving reliance").

67. *Basic Inc.*, 485 U.S. at 226–27.

68. *Id.* at 227.

69. *Id.* at 227–28.

70. *Id.* at 228.

The Supreme Court approved a rebuttable presumption of reliance for fraud-on-the-market, holding that the presumption is consistent with the purposes of § 10(b) because it facilitates Rule 10b-5 litigation.⁷¹ The Court further held that “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.”⁷² *Basic* is significant because it provides a way for plaintiffs to certify their case as a class action without showing individual reliance upon the misrepresentations or omissions made by the defendant—a difficult, if not impossible, task. In the wake of *Basic*, it appeared that Rule 10b-5 protection for individual investors was expanding.

C. Liability for Secondary Actors: Entering the Forest

1. *Central Bank* and its Impact on Secondary Liability

The era of an expansive Rule 10b-5 was short-lived.⁷³ Traditionally, secondary liability claims were brought under aiding and abetting causes of action,⁷⁴ born out of general concepts of tort law.⁷⁵ However, questions about the continued availability of secondary liability claims emerged when the Supreme Court began focusing more closely on the statutory text of § 10(b) and, consequently, its progeny, Rule 10b-5.⁷⁶ Gradually, various lower court decisions began to restrict and eventually eliminate aiding and abetting liability under § 10(b), signaling that the era of expansive plaintiffs’ rights was ending.⁷⁷

71. *Id.* at 245.

72. *Id.* at 248.

73. Indeed, even before *Basic*, the Court criticized broad class actions under Rule 10b-5 as being “light years away” from the original tort of misrepresentation and deceit. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744–45 (1975).

74. See *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983) (discussing the test to determine liability as an aider and abettor of a violation of § 10(b) or Rule 10b-5); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740 (10th Cir. 1974) (“Under § 10(b) and Rule 10b-5 knowing assistance of or participation in a fraudulent scheme gives rise to liability equal to that of the perpetrators themselves.”).

75. *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966).

76. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977) (noting that the “starting point in every case involving construction of a statute is the language itself”); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976) (“Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section.”).

77. See *Akin v. Q-L Invs., Inc.*, 959 F.2d 521, 525 (5th Cir. 1992) (“There is a powerful argument that . . . aider and abettor liability should not be enforceable by private parties

The Supreme Court stifled plaintiffs' ability to bring claims against secondary actors in *Central Bank of Denver v. First Interstate Bank of Denver*, holding that Rule 10b-5 does not encompass aiding and abetting liability. In *Central Bank*, the Colorado Springs-Stetson Hills Public Building Authority ("Authority") issued twenty-six million dollars worth of bonds in 1986 and 1988 to finance public improvements, with Central Bank of Denver ("Central Bank") serving as indenture trustee.⁷⁸ The developer AmWest Development ("AmWest") was responsible, per the bond covenants, for providing evidence that the land was worth a minimum of 160 percent of the value of the bond issues⁷⁹ and giving annual updated appraisals to Central Bank.⁸⁰ In 1988, Central Bank became aware that the lands might not be worth 160 percent of the value of the bonds, but after discussions with AmWest, Central Bank delayed obtaining an independent appraisal for six months.⁸¹ Unfortunately, the Authority defaulted on the 1988 bonds before the independent appraisal was conducted.⁸² First Interstate Bank of Denver ("FIB") and Jack Naber, holders of 2.1 million dollars worth of the defaulted 1988 bonds, brought suit against Central Bank, claiming that Central Bank had aided and abetted in the fraud by delaying the independent appraisal.⁸³ The Supreme Court held that the statutory language of § 10(b), the basis for Rule 10b-5, does not encompass aiding and abetting liability.⁸⁴ It reached this conclusion by comparing the Exchange Act containing § 10(b) to other acts of Congress that clearly showed an intent to create aiding and abetting liability, and it found such an intent lacking in § 10(b).⁸⁵ The Court then went a step further, noting that no other private causes of action under the Exchange Act supported allowing aiding and abetting liability.⁸⁶ The

pursuing an implied right of action."); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986) (requiring a manipulative or deceptive act to be liable under § 10(b)). See generally Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 81 (1981) (discussing secondary liability and § 10(b)).

78. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 167 (1994).

79. *Id.*

80. *Id.*

81. *Id.* at 168. This fact is significant because by the end of the six month delay, the 1988 bond issue was already closed out.

82. *Id.*

83. *Id.*

84. *Id.* at 191; see also 18 U.S.C. § 2 (2000) (showing Congress's ability to clearly delineate an aiding and abetting regime).

85. *Cent. Bank of Denver*, 511 U.S. at 176-77.

86. *Id.* at 179 (citing 15 U.S.C. §§ 77k, 78i, 78p, 78r); cf. *Commodity Exchange Act*, 7 U.S.C. § 25(a)(1) (creating a private aiding and abetting cause of action).

Supreme Court even rejected the SEC's amicus curiae policy argument that allowing aiding and abetting would deter secondary actors from participating in a fraudulent activity. The Court stated that such liability "exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets,"⁸⁷ noting that the nature of secondary liability "demands certainty and predictability."⁸⁸ The Court then went on to discuss the ripple effect that would be created if there were a broad basis for liability because small businesses would be unable to afford professional advice.⁸⁹ Further, businesses that could afford professional advice would pass the additional costs to their clients and their investors, whom the statutes were meant to protect.⁹⁰

The *Central Bank* Court did, however, state that defrauded parties are not without a remedy, explaining that lawyers, accountants, and bankers may nevertheless be liable as primary violators, "assuming *all* of the requirements for primary liability under Rule 10b-5 are met."⁹¹

The Supreme Court's decision in *Central Bank* seemed to sound the death knell for secondary liability claims by imposing a higher burden on plaintiffs attempting to recover from secondary actors. Rather than simply demonstrating the three elements necessary for an aiding and abetting claim, plaintiffs must now demonstrate a primary violation of Rule 10b-5 to survive a motion to dismiss.⁹² This is a tall order indeed.

2. The Circuit Split over Rule 10b-5(b) Misrepresentation Claims

Plaintiffs responded to *Central Bank* primarily by filing misrepresentation claims under Rule 10b-5(b) against secondary actors.⁹³ Yet federal circuit courts struggled with how to respond to

87. *Cent. Bank of Denver*, 511 U.S. at 188; see also Brief for the SEC as Amicus Curiae Supporting Respondents at 16–17, *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (No. 92-854) (discussing various SEC policies supporting secondary liability under Rule 10b-5).

88. *Cent. Bank of Denver*, 511 U.S. at 188.

89. *Id.* at 189.

90. *Id.*

91. *Id.* at 191.

92. The three elements of an "aiding and abetting cause of action in the Tenth Circuit [are]: (1) a primary violation of § 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor." *Id.* at 168 (citing *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898–903 (1992)).

93. See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 171 (2d Cir. 1998) (charging Ernst & Young, the outside auditor for BT Office Products, with making "materially false and misleading financial statements to the public"); *Shapiro v. Cantor*, 123 F.3d 717, 720–21 (2d Cir.

these claims in light of *Central Bank*. This struggle has produced four different approaches to distinguishing primary liability from aiding and abetting in a Rule 10b-5(b) misrepresentation claim. The Second Circuit developed the Bright Line Test; the Ninth Circuit announced the Substantial Participation Test; the Tenth Circuit announced an *Anixter* Test; and the SEC has proposed its own test, in what has become known as the Creator (or Creation) Test.

a. Bright Line Test

By focusing on whether the defendant made a false or misleading statement, the Bright Line Test seeks to create an easy-to-apply standard. The Second Circuit announced this test in *Shapiro v. Cantor*⁹⁴ and refined it further in *Wright v. Ernst & Young, LLP*.⁹⁵ The *Shapiro* court opined that

if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).⁹⁶

It further required that the defendant knows or should know that his or her misrepresentation or omission would reach potential investors.⁹⁷

In *Wright*, the plaintiffs brought suit against Ernst & Young as a secondary actor for damages caused by the release of misleading financial statements by a company for whom Ernst & Young served as an outside auditor.⁹⁸ The court refused to find liability under the Bright Line Test, noting that the misrepresentation must be attributed to the defendant at the time of public dissemination.⁹⁹ In this case, the press release was not attributed to Ernst & Young, as

1997) (examining plaintiffs joinder of Touche Ross & Co.); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1218 (10th Cir. 1996) (examining judgments against Home-Stake's outside auditor for violating § 10(b) and Rule 10b-5); *In re Software Toolworks Inc. v. Painewebber Inc.*, 50 F.3d 615, 620 (9th Cir. 1994) (bringing a class action against underwriters and auditors); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 563-64 (S.D. Tex. 2002) (bringing suit against accounting firms, law firms, and investment banks/integrated financial services institutions).

94. *Shapiro*, 123 F.3d at 720-21.

95. *Wright*, 152 F.3d at 175.

96. *Shapiro*, 123 F.3d at 720 (quoting *In re MTC Elec. Techs. S'holders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995)).

97. *Id.*

98. *Wright*, 152 F.3d at 171.

99. *Id.* at 175.

the outside auditor merely failed to prevent the misleading statements from being released but did not make the misrepresentation.¹⁰⁰

b. Anixter Test

The Tenth Circuit test, set out in *Anixter v. Home-Stake Production Co.*, is similar to the Second Circuit's Bright Line Test. In *Anixter*, Home-Stake offered its investors oil and gas investments that were actually elements of a Ponzi scheme: later investments financed the "returns" for earlier investors.¹⁰¹ Defrauded investors brought suit against, *inter alia*, Cross, the independent auditor who prepared documents for use by Home-Stake in SEC filings and other financial releases.¹⁰² The court held that, for a plaintiff to prevail against a secondary actor for misrepresentation, he or she must prove: (1) that the defendant made an untrue statement of material fact or omitted a material fact, (2) that the conduct occurred in connection with the purchase or sale of a security, (3) that the defendant made the statement or omission with scienter, and (4) that the plaintiff relied on the misrepresentation and sustained damages as a proximate result of the misrepresentation.¹⁰³ Further, to establish the connection to a purchase or sale of a security, the plaintiff must show that the defendant knew or should have known that his or her statement or omission would be communicated to investors.¹⁰⁴

Applying its new test, the court held that the independent auditor Cross could be found liable because, while acting as Home-Stake's independent auditor, he certified Home-Stake's financial statements and distributed his certifications and opinions widely in prospectuses, annual reports, and registration statements.¹⁰⁵ An expert also testified in the case that Cross knew or should have known that the statements were misleading and would reach potential investors.¹⁰⁶

c. Substantial Participation Test

The Ninth Circuit endorses a very broad Substantial Participation Test, developed in *In re Software Toolworks Inc. v.*

100. *Id.*

101. *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1218 (10th Cir. 1996).

102. *Id.* at 1219.

103. *Id.* at 1225.

104. *Id.*

105. *Id.* at 1227.

106. *Id.*

*Painewebber Inc.*¹⁰⁷ The plaintiffs in *Painewebber* were investors in a secondary public offering of a software firm whose stock became available at eighteen dollars and fifty cents per share.¹⁰⁸ They brought suit three months later when a press release about substantial losses caused the stock to plummet to two dollars and thirty-eight cents per share.¹⁰⁹ Among the claims they alleged was a Rule 10b-5(b) violation against the firm's auditor, Deloitte & Touche, in relation to a fraudulent letter filed with the SEC claiming there were no quarterly financial data available.¹¹⁰

The court stated that an actor need not "make" the misleading statements, but merely "substantially participate" in the preparation of the statements, or otherwise be "intricately involved" in their preparation, to be found liable.¹¹¹ In what is essentially a scienter element, the actor also must know, or be reckless in not knowing, that the information constitutes a material misrepresentation.¹¹²

The court held that although the plaintiffs' claim against Deloitte & Touche was similar to aiding and abetting, which *Central Bank* prohibits, the claim could proceed because the complaint alleged primary liability violations as well.¹¹³ Specifically, one of the letters to the SEC stated that the letter " 'was prepared after extensive review and discussions with . . . Deloitte' and actually referred the SEC to two Deloitte partners for further information," which tended to show substantial participation in the misrepresentation.¹¹⁴ Further, the court held that a reasonable fact finder could infer that Deloitte had access to the quarterly financial data and either knew or should have known that the letter to the SEC was false, satisfying the last element of the test.¹¹⁵

d. Creator Test

The SEC developed its own interpretation of the proper role of Rule 10b-5 private actions and secondary actors in an amicus brief filed in *Klein v. Boyd*. Under the SEC's Creator Test, a secondary actor is liable when, acting alone or in concert with others, he or she creates

107. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994).

108. *Id.* at 620.

109. *Id.*

110. *Id.*

111. *Id.* at 628 n.3.

112. *Id.* at 629.

113. *Id.* at 628 n.3.

114. *Id.*

115. *Id.* at 629.

a misrepresentation and has the requisite scienter.¹¹⁶ The SEC included explanatory hypotheticals to demonstrate that an actor could be primarily liable if he or she writes misrepresentations for inclusion in a document given to investors, even if the ideas came from somebody else.¹¹⁷ An actor who writes a truthful section for an otherwise fraudulent document, however, will not be held liable for misrepresentations in other parts of the document because that actor did not “create” those misrepresentations.¹¹⁸

In the era of the Enron scandal, the Creator Test has only been adopted in one Texas district court.¹¹⁹ In *In re Enron Corporation Securities*, the court deferred to the SEC under traditional administrative law principles, concluding that the SEC’s Creator Test was not arbitrary or capricious.¹²⁰ It hailed the Creator Test as balancing the rights of fraud victims against the need to protect secondary parties from meritless suits.¹²¹ The court criticized approaches that limit liability solely to misrepresentations, omissions, and a few “very technical forms of manipulation.”¹²²

3. The Circuit Split over Rule 10b-5(a) and (c) Scheme-to-Defraud Claims

In response to the increased difficulty in bringing a Rule 10b-5(b) claim against secondary actors, plaintiffs began making creative arguments to pursue claims under Rule 10b-5(a) and (c), alleging the existence of fraudulent schemes.¹²³ The courts of appeals again split, creating more confusion over secondary actor liability: the Ninth Circuit announced the Principal Purpose Test, while the Eighth Circuit used the narrower Duty Test.

116. The “requisite scienter” loosely means deliberately or recklessly. *SEC Brief*, *supra* note 27, at 14.

117. *Id.* at 13–14.

118. *Id.* at 14–15.

119. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002).

120. *Id.*

121. *Id.* at 590.

122. *Id.* at 589 n.31.

123. Mark S. Pincus, Note, *Circuit Split or a Matter of Semantics? The Supreme Court’s Upcoming Decision on Rule 10b-5 “Scheme Liability” and its Implications for Tax Shelter Fraud Litigation*, 76 FORDHAM L. REV. 423, 448–49 (2007).

a. Principal Purpose Test

The California State Teachers' Retirement System ("CalSTRS") brought a scheme-to-defraud claim in *Simpson v. AOL Time Warner* against Homestore.com under Rule 10b-5(a) and (c).¹²⁴ CalSTRS alleged that Homestore.com initially overstated its revenues by \$170 million and that AOL Time Warner ("AOL"), engaged in fraudulent sham transactions with Homestore.com, which essentially allowed Homestore.com to purchase its own revenue.¹²⁵ Homestore.com would then record this fake revenue as an asset on the financial statements it reported to the SEC.¹²⁶

Addressing the scheme-to-defraud claim, the court stated that the Ninth Circuit looks to whether the actor has committed a manipulative or deceptive act to find liability under Rule 10b-5(a) and (c). To be liable for engaging in a "scheme to defraud," the actor must have "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme."¹²⁷ It is not enough that an actor participate in a transaction that has a deceptive purpose and effect, however; the actor's own conduct must have had a deceptive purpose and effect.¹²⁸

The court went on to hold that CalSTRS failed to show that AOL had acted with the principal purpose and effect of creating a false appearance in furtherance of a scheme.¹²⁹ AOL's transactions with Homestore.com could be legitimate; it was only after Homestore.com manipulated its relationship with third-party vendors that AOL's transactions became fraudulent.¹³⁰ Thus, CalSTRS could not demonstrate that the "principal purpose" of the transactions was deception. The court held that dismissal of the claims against the other third-party vendors was appropriate for similar reasons.¹³¹

b. Duty Test

The Eighth Circuit established a much narrower view of liability for secondary actors in *Stoneridge Investment Partners, LLC*

124. *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1042 (9th Cir. 2006).

125. *Id.*

126. *Id.*

127. *Id.* at 1048.

128. *Id.*

129. *Id.* at 1053.

130. *Id.*; see also *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005) ("Any deceptiveness resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere.").

131. *Simpson*, 452 F.3d at 1053–54.

*v. Scientific-Atlanta, Inc.*¹³² The plaintiffs filed suit under § 10(b) of the Exchange Act and Rule 10b-5, alleging that Charter Communications' ("Charter") suppliers, Scientific-Atlanta, Inc. and Motorola, Inc., participated in a scheme to defraud Charter shareholders.¹³³ The scheme involved selling cable converter boxes to Charter at inflated prices.¹³⁴ The suppliers then "refunded" the extra money by purchasing advertising with Charter.¹³⁵ The suppliers produced falsely backdated documents to make the transactions look unrelated in an effort to deceive Charter's auditor.¹³⁶

The district court granted the suppliers' motion to dismiss for failure to state a claim, and the Eighth Circuit affirmed.¹³⁷ The Eighth Circuit rejected the plaintiffs' argument that the defendants engaged in a scheme to defraud by "engaging in a 'course of business which [sic] operates . . . as a fraud or deceit.'" ¹³⁸ The court reasoned, "A device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose."¹³⁹ The court went on to find no duty between the suppliers and Charter's investors and, subsequently, no liability.¹⁴⁰ The court also clarified that "manipulative," as used in § 10(b), is a term of art that refers to transactions that artificially affect market price, such as wash sales and rigged pricing.¹⁴¹

In *Regents of the University of California v. Credit Suisse*, the Fifth Circuit acknowledged the split between the Eighth and Ninth Circuits and elected to follow the Eighth Circuit's Duty Test.¹⁴² The plaintiffs, including Buddy Schwartz, alleged that the defendant banks participated in a fraudulent scheme with Enron by structuring illogical transactions and manipulating Enron's financial statements.¹⁴³ After discussing relevant precedent,¹⁴⁴ the Fifth Circuit held that the defendant banks doing business with Enron had no duty

132. *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 987–93 (2006).

133. *Id.* at 989–90.

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 993.

138. *Id.* at 991.

139. *Id.* at 992.

140. *Id.* at 992–93.

141. *Id.* at 990.

142. *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 386–87 (5th Cir. 2007).

143. *Id.* at 377.

144. *Id.* at 386–90. *See supra* note 21 (discussing two cases that the Fifth Circuit relied on to support its duty requirement for a finding of liability).

to the plaintiffs and that only Enron had a duty of disclosure.¹⁴⁵ At most, the court was willing to believe that the banks could be guilty of aiding and abetting, neither of which establishes a claim under § 10(b) or Rule 10b-5.¹⁴⁶

4. *Stoneridge Investment Partners* and Scheme Liability

The Supreme Court recently addressed the circuit split over Rule 10b-5 (a) and (c) scheme liability in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,¹⁴⁷ which was on appeal from the Eighth Circuit case mentioned *supra*. The Supreme Court also rejected the plaintiffs narrow interpretation of *Central Bank* and scheme liability, utilizing a somewhat different analytical framework. It first reiterated that the plaintiff's reliance "is an essential element of the § 10(b) private cause of action."¹⁴⁸ The Court then discussed two presumptions of reliance: the fraud-on-the-market presumption, as announced in *Basic*, and the Eighth Circuit's duty-based presumption at issue when an actor has a duty to disclose material information to the market and omits a material fact.¹⁴⁹ The Court went on to hold that because Charter's vendors were dealing in the market for goods and services and not in the market for financial investments, their deceptive acts were too remote to have persuaded the Stoneridge investors to purchase Charter securities.¹⁵⁰ The Court thus affirmed the Eighth Circuit's decision and effectively eliminated the Principal Purpose Test for scheme liability.

The Court also expressed reservation over expanding the judicially created private cause of action because of Congress's perceived refusal to do so through the Private Securities Litigation Reform Act of 1995 ("PSLRA"),¹⁵¹ discussed *infra* in subsection D. Citing both the text of 15 U.S.C. § 78u-4(b) (the codification of § 10(b)) and former SEC Chairman Arthur Levitt's testimony before the Senate Securities Subcommittee, the Court assumed that "Congress accepted the § 10(b) private cause of action as [defined during the enactment of the PSLRA] but chose to extend it no further."¹⁵² This

145. *Id.* at 390.

146. *Id.*

147. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770–75 (2008).

148. *Id.* at 769.

149. *Id.*

150. *Id.* at 769–70.

151. Private Securities Litigation Reform Act of 1992, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

152. *Stoneridge*, 128 S. Ct. at 768–79, 773.

indicates that any additional expansion of Rule 10b-5 claims will have to come from Congress, at least in the short term. This result also cripples plaintiffs' ability to bring creative scheme-to-defraud claims under Rule 10b-5(a) and (c).

D. Congressional Responses

The judiciary is not alone in its attempts to refine the Rule 10b-5 doctrine; Congress has tipped its hand in a few ways that have consequences for plaintiffs like Buddy Schwartz. First, Congress passed the PSLRA, which imposed a number of requirements on securities plaintiffs. Congress later passed the Sarbanes-Oxley Act ("SOX"), which holds import for this discussion because of its Fair Funds provision.

In the early 1990s, Congress was increasingly persuaded by scholarship suggesting that private securities litigation had transaction costs that were too high.¹⁵³ In response, Congress enacted the PSLRA. Among its provisions is a heightened pleading requirement for Rule 10b-5 claims, requiring that the "complaint [] specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."¹⁵⁴ If there is a state-of-mind requirement, then the complaint shall also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹⁵⁵ As a result of the PSLRA, it is now easier to dispose of Rule 10b-5 claims upon a motion to dismiss.¹⁵⁶

In addition to the PSLRA, Congress passed SOX in 2002 to reform securities litigation. The so-called "Fair Funds" provision of SOX allows the SEC, in an enforcement action, to distribute any

153. See John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 726–27 (1986) (criticizing the class action method of enforcement as being economically inefficient); Rose, *supra* note 33, at 1318–20 (discussing the history of the PSLRA); see also Brown, *supra* note 40, at 15 (quoting *Bankers Ethics*, WALL ST. J., June 16, 2005, at A16) (criticizing the class action mechanism as primarily shifting money to the attorneys involved).

154. 15 U.S.C. § 78u-4(b)(1)(B) (2000).

155. *Id.* § 78u-4(b)(2).

156. *Id.* § 78u-4(b)(3); Rose, *supra* note 33, at 1319. Although the PSLRA also created a safe harbor for forward-looking statements, it is not particularly relevant to this discussion because this safe harbor would still not protect fraudulent statements. See Ann Morales Olazabal, *Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What's Safe and What's Not?*, 105 DICK. L. REV. 1, 4–6 (2000) (discussing the PSLRA safe harbor provision).

disgorged profits from a securities violator to the victims.¹⁵⁷ This provision has been touted as indirectly motivating the SEC to seek stiffer fines against certain market professionals.¹⁵⁸

III. MOVING TOWARDS A UNITARY STANDARD OF SECONDARY ACTOR LIABILITY: SCRUTINIZING THE CIRCUIT TESTS IN LIGHT OF POLICY CONSIDERATIONS

The evolution of Rule 10b-5 reveals several foundational principles underlying the securities markets and their regulation. Understanding these principles is essential to analyzing the various circuit tests. Among these principles are fairness,¹⁵⁹ honesty, increased disclosure, certainty, predictability, and economic efficiency.¹⁶⁰ This Part analyzes each of the circuit tests for misrepresentation or omission and scheme liability in light of the preceding themes.

A. Rule 10b-5(b) Misrepresentation Claim Tests

1. Bright Line Test

The Second Circuit's Bright Line Test attempts to embrace the concepts of certainty and predictability. This test clearly delineates that the actor must make a false or misleading statement in order to be found liable.¹⁶¹ However, the Bright Line Test has been criticized for its ambiguous use of the word "make." The test requires that the defendant "make" a false or misleading statement with actual or constructive knowledge that his or her representation will reach potential investors.¹⁶² While purporting to establish a predictable bright line rule, this approach overlooks a fundamental problem: it fails to address whether the actor need only assist in the preparation

157. 15 U.S.C. § 7246; 17 C.F.R. §§ 201.1100-06 (2008).

158. James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Model*, 53 DUKE L.J. 737, 754 (2003).

159. Any viable solution must appropriately balance the need to protect investors from fraudulent information and the need to protect businesses against meritless strike suits. This balancing act is often discussed in terms of overdeterrence or underdeterrence. See Rose, *supra* note 33, at 1303-06.

160. I use "economic efficiency" broadly to indicate any situation where resources are being used at their maximum level of utility, including maximizing judicial resources, reducing plaintiffs' litigation costs, etc.

161. *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).

162. Caskey, *supra* note 66, at 442.

of misleading documents or whether the actor must personally draft the misleading statement to be liable. It is also unclear what result occurs if the actor is merely transcribing what another person is telling him. The ambiguous nature of this test makes it less than a bright line rule, and thus the test fails to fully embrace certainty or predictability.¹⁶³

The Bright Line Test does have the benefit of increasing economic efficiency, however. Attorneys, accountants, bankers, and similar professionals can provide their services without fear of reprisal because they have advance knowledge of their exposure to liability based upon whether they are making a false or misleading statement that they expect to be publicly disseminated. If there is any question as to the honesty of any disclosures, the secondary actor has the option to associate himself with the suspect documents or statements or not. Being able to judge exposure to liability would significantly enhance economic efficiency because a secondary actor could potentially raise his rates when business dealings posed a greater risk of legal liability and maintain normal fees when dealings involve full and honest disclosure. Ideally, all disclosures should be full, fair, and honest, but this risk-shifting passes higher costs to firms seeking secondary parties to assist in defrauding the public while protecting the public at large from the higher prices predicted by the court in *Central Bank*.

Additionally, the requirement that the actor knows, or should know, that the misrepresentation will reach potential investors¹⁶⁴ further increases economic efficiency. Outside professionals involved in creating documents not meant for public dissemination do not have to worry about liability that might, for example, be possible under a broad scope of liability similar to that in the Substantial Participation Test. Because there would be no liability if no potential investors are involved, the fees charged for services would likely be lower.

However, the Bright Line Test has been criticized frequently for creating what has been called a "safe harbor."¹⁶⁵ The *Wright* court held that a misleading statement must be attributed to the alleged wrongdoer at the time of its public dissemination, and it is precisely this attribution requirement that the SEC and others have criticized

163. The SEC has attempted to address the ambiguity of "makes" in their Creator Test. See *infra* Part III.A.4 (describing the elements of the Creator Test).

164. *Shapiro*, 123 F.3d at 720.

165. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 587 (S.D. Tex. 2002) (quoting *SEC Brief*, *supra* note 27).

as being too protective.¹⁶⁶ This requirement creates a safe harbor whereby a cunning wrongdoer will not be exposed to liability if he simply avoids the association of his name with the misleading statement at the time of its dissemination,¹⁶⁷ regardless of his actual responsibility. This creates an end run around the goals of fairness, honesty, and full disclosure. However, the goal of economic efficiency still is maximized if a secondary actor takes advantage of the safe harbor by declining to be associated with the misleading documents or statements because only the business issuing the misleading documents or statements assumes the risk of legal liability. Thus the secondary actor will not charge inflated prices because there is no additional risk or legal liability.

2. *Anixter* Test

The *Anixter* Test is similar in many aspects to the Bright Line Test, and the two tests share many of the same praises and criticisms. The primary difference is that the *Anixter* Test does not have an attribution requirement. It only requires the plaintiff to prove that: (1) the defendant made an untrue statement of material fact or omitted a material fact; (2) the conduct occurred in connection with the purchase or sale of a security; (3) the defendant made the statement or omission with scienter; and (4) the plaintiff relied on the misrepresentation, sustaining damages as a proximate result of the misrepresentation.¹⁶⁸ Secondary actors making a misleading statement can be held liable, even if their names are nowhere on the document. The effect is twofold: first, economic efficiency may decrease if a broad scope of liability affects the willingness of professionals to assist in document preparation at a reasonable cost; and second, investors are more likely to trust the integrity and fairness of the market. With an increased likelihood of legal liability under this broad standard, professionals likely will charge their customer businesses higher prices, resulting in higher transaction costs that will trickle through the economy. However, with a broader range of liability, investors are more likely to

166. See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (refusing to use the attribution requirement); *In re Enron*, 235 F. Supp. 2d at 587; (calling the attribution requirement "too expansive"); *SEC Brief*, *supra* note 27, at 14 (criticizing the attribution requirement).

167. The court discusses another case where an accountant is not held liable for only "reviewing and approving" financial statements, which indicates that attribution requires the actor to have written the material. See *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (refusing to find Price Waterhouse liable unless they actually "engag[ed] in the reporting of financial statements").

168. See *supra* Part II.C.2.b (describing the four factors of the *Anixter* Test).

trust the accuracy of information in the market because businesses, fearing liability, are more likely to disclose fully and honestly.

Like the Bright Line Test, the *Anixter* analysis also suffers from the ambiguous use of the word “make” when it bases liability on those who make a misleading statement.¹⁶⁹ Without a more definite explanation of the exact conduct that the test prohibits, this test fails to offer the level of certainty and predictability sought by the Supreme Court. Secondary actors have no guarantee that what was previously acceptable conduct would not suddenly be judicially held to be prohibited conduct constituting the “making” of an untrue statement.

3. Substantial Participation Test

In contrast to the “narrowness” criticisms of the Bright Line and *Anixter* Tests, the Substantial Participation Test has been criticized as too broad.¹⁷⁰ The primary concern with the Ninth Circuit’s approach is that there is no bright line establishing where liability begins or ends. The ambiguity of the term “substantial participation” curtails *Central Bank’s* goals of certainty and predictability. It is possible for an actor with a seemingly minimal role to be found equally as liable as the primary violator because he “substantially participated” in preparing the misleading statements. This offends traditional concepts of justice and culpability. Further, professionals are dissuaded from providing services to businesses because there is no way to establish how much risk of legal liability exists.¹⁷¹ This creates incentives for costs to be passed on to the public as the Court feared in *Central Bank*. Moreover, this not only could result in increased costs, but could, as one commentator suggests, actually decrease the ability of firms to provide full and fair disclosure.¹⁷²

The Ninth Circuit test shies away from the reliance requirement typically inherent in Rule 10b-5 claims.¹⁷³ Because secondary actors can be found liable without any showing that the

169. *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996).

170. See Caskey, *supra* note 66, at 442 (concluding that the Substantial Participation Test “overreaches”).

171. See Mary M. Wynne, *Primary Liability Amongst Secondary Actors: Why the Second Circuit’s “Bright Line” Standard Should Prevail*, 44 ST. LOUIS U. L.J. 1607, 1625 (2000) (discussing how fear of legal liability may lead lawyers and accountants to hesitate before agreeing to help their clients with securities transactions).

172. *Id.* at 1625–26.

173. See *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (discussing the reliance requirement).

plaintiff relied on the misleading statements,¹⁷⁴ this test perhaps oversteps the bounds of reasonableness in pursuing fairness and disclosure in the markets. It is unclear how there can be damages if there is no reliance on the misrepresentation.

The role of a secondary actor also affects liability under this standard. The more intimate the relationship between a secondary actor and the business, the more likely that the secondary actor will be subject to liability.¹⁷⁵ This deters secondary actors from providing services to firms involved in issuing securities. Again, the effect is to increase costs of services, which reduces overall economic utility. For example, in *McGann v. Ernst & Young*, the court rejected an independent auditor's argument that liability should be limited to those actually trading in securities.¹⁷⁶ In essence, any party with any level of involvement could be found liable if he knew or was reckless in not knowing that there was a material misrepresentation being created. Not only does this open to liability actors with minimal involvement; it also increases the likelihood that more frivolous lawsuits will be filed.

4. Creator Test

While the Creator Test was adopted by the very agency charged with developing and enforcing securities law, it has only been adopted by one district court.¹⁷⁷ The primary strength of the Creator Test is that it tries to strike a balance between the narrow Bright Line and *Anixter* Tests and the overly broad Substantial Participation Test.

Like the *Anixter* standard, the Creator Test avoids the safe harbor problem inherent in the Bright Line Test. Under the SEC standard, an actor need not be named on the document to be found liable. If the actor assisted in creating the misrepresentation, he is liable. By avoiding the attribution problem, the goals of honesty, fairness, and disclosure in the market are achieved by eliminating the incentive to disassociate oneself fraudulently from a document, which exists under the Bright Line Test.¹⁷⁸

174. See *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 973 (C.D. Cal. 1994) (describing the shifting focus of the reliance requirement).

175. See Wynne, *supra* note 171, at 1625 (discussing problems with the Substantial Participation Test).

176. *McGann v. Ernst & Young*, 102 F.3d 390, 395 (9th Cir. 1996).

177. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002).

178. See Caskey, *supra* note 66, at 440. (arguing that the Creator Test "maintains market integrity by offering a clear standard of liability aimed at those centrally involved in misrepresentations to investors").

The Creator Test arguably enhances predictability and certainty by providing a clear meaning for the term “create.” The SEC gave concrete examples of “creation” when announcing its test in the *Klein* brief, which the SEC filed as amicus curiae, in an attempt to avoid the ambiguity problem that plagues the other standards.¹⁷⁹ Despite these examples, however, this test has been criticized for using imprecise language.¹⁸⁰ This concern stems from the fact that, even with examples, “create” is still a word subject to manipulation and interpretation, just like “makes,” which has been criticized in other tests. For example, the Creator Test has been praised for “casting a wider net”¹⁸¹ than the other tests, yet the same commentator emphasized that “the net could spread far and wide, making the [Creator Test] a mere alternative version of the Substantial Participation [T]est.”¹⁸²

Excerpts from the *Klein* brief also indicate that under this standard there likely would be less meritless litigation. Unlike the broad Substantial Participation Test, under which an actor who did not create a misrepresentation could nevertheless be found liable for substantially participating in that creation, the SEC examples clearly show that a secondary actor whose role was limited to drafting honest portions of a document is free from liability, even if he or she knew that other portions of the document were fraudulent, because he or she did not create them.¹⁸³ A smaller volume of litigation would conserve economic resources and would also incentivize secondary actors to be honest in their actions, thus increasing market integrity.

It is worth noting, finally, that the SEC itself conceived the Creator Test. Under traditional administrative law principles, courts defer to agency interpretations of both organic statutes and their own rules.¹⁸⁴ Thus far, this test has only been proffered in the *Klein* brief and the Enron litigation in a Texas district court, so most courts have not been confronted with the issue of acknowledging the level of deference due the SEC. Admittedly, the private right of action is judicially created, so courts are not required to defer to the SEC’s

179. *SEC Brief*, *supra* note 27, at 14–15.

180. *See Caskey*, *supra* note 66, at 446 (arguing that the Creator Test still “need[s] clarification”).

181. *Id.* at 449.

182. *Id.*

183. *SEC Brief*, *supra* note 27, at 14–15.

184. *See Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 413 (1945) (stating that a “court must necessarily look to the administrative construction of the regulation if the meaning of the words used is in doubt”).

interpretation.¹⁸⁵ However, it is equally important to remember that the SEC is tasked with maintaining fair and honest markets, so its opinion should be given some influential weight. If the Creator Test were to gain wider acceptance, the SEC would be in a position to address any problems without necessarily burdening the courts by using its adjudication functions. However, this benefit is likely to remain overlooked because the private right of action under Rule 10b-5 was judicially created.¹⁸⁶

B. Rule 10b-5(a) and (c) Schemes to Defraud After Stoneridge

The Supreme Court's framework for scheme liability is simple in theory, but it still leaves much to be desired in its application and will need to be fleshed out in future litigation. It is clear that reliance is an important, required element in a Rule 10b-5 action in light of *Stoneridge*.¹⁸⁷ What is required to establish reliance, however, remains a mystery.

In *Stoneridge*, the Court found that the connection between the altered financial documents and the Stoneridge investors was too attenuated to establish liability.¹⁸⁸ This was held to be true even though the suppliers knew or should have known that Charter was going to use the altered documents in preparing its financial statements for investors. This begs the question of how close the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury"¹⁸⁹ must be before reliance is found. Although the Court implies that no specific oral or written statement is necessary,¹⁹⁰ the Court never states what *is* required. The likely result is an increase in litigation as plaintiffs attempt to discover the defining line, which may affect the costs of doing business.

185. The Business Roundtable has argued that judicial deference to the SEC on this issue is inappropriate because: (1) Congress has consistently declined to follow the SEC's suggestions on Rule 10b-5, indicating clear congressional intent; and (2) Congress has not delegated authority to the SEC to create, or regulate, a private right of action under Rule 10b-5; it was a judicially created right. Brief of the Business Roundtable as Amicus Curiae at 5, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008) (No. 06-43), available at http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/06-43_RespondentAmCuBusRound.pdf.

186. *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798, 802 (E.D. Pa. 1947).

187. See *Stoneridge*, 128 S. Ct. at 769 ("Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action.").

188. *Id.* (rejecting plaintiff's reliance argument because, "[w]ere this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace").

189. *Id.* (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988)).

190. *Stoneridge*, 128 S. Ct. at 769 ("If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous.").

Further, the Eighth Circuit's Duty Test, which the *Stoneridge* Court adopted as a rebuttable presumption of reliance, is very narrow in its application. By incorporating a duty analysis, this test remains faithful to the original tort concepts that guide § 10(b) analysis. However, this standard is imprecise because there is no definition of the scope of the duty required. The Fifth Circuit in *Regents of the University of California v. Credit Suisse First Boston* did not define the duty but stated that Enron had a duty to its shareholders while the defendant banks did not.¹⁹¹ The court also implied that a misleading statement is required, but a mere deceptive act is insufficient, to satisfy the duty requirement.¹⁹² Furthermore, a bank's fiduciary duty to its clients is not enough to establish a legal duty necessary for secondary-actor scheme liability. The Eighth Circuit was more helpful, stating in *In re Charter Communications, Inc., Securities Litigation* that the defendant vendors were not under a duty to investors and analysts to disclose information useful in evaluating Charter's true financial condition.¹⁹³ The Supreme Court, while acknowledging the validity of the duty analysis, failed to provide any clarity as to the origin of the duty.¹⁹⁴

This duty analysis is problematic because, like the safe harbor concerns in misrepresentation claims under the Bright Line Test, the Duty Test allows secondary actors to bypass liability as long as they are not under a particular duty to provide accurate information. In fact, this standard enables secondary actors to circumvent completely the goals of honesty and fairness in the markets. This is exactly what happened with Enron and Merrill Lynch in *Regents*, which devastated investors like Schwartz who relied on Merrill Lynch. Because Merrill Lynch owed no duty to Schwartz, he cannot recover damages against Merrill Lynch, even though Merrill Lynch arguably is culpable and should be held liable. As a result of experiences like that of Schwartz, investors lose confidence in the market.

191. *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 386 (5th Cir. 2007).

192. *Id.*

193. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 443 F.3d 987, 992 (8th Cir. 2006).

194. See generally *Stoneridge*, 128 S. Ct. at 769.

IV. A UNITARY STANDARD OF LIABILITY THAT RESTORES THE AMERICAN DREAM BY CHOPPING DOWN THE FOREST

A. The Need for a Unitary Standard

The courts of appeals have gone in vastly different directions in response to the Supreme Court's holding in *Central Bank* regarding secondary actor liability. Subsequent congressional and judicial attempts at clarifying secondary actor liability have not been entirely successful. The product has been inconsistency in the law, and the resulting situation has been compared to a Hobson's choice for securities lawyers.¹⁹⁵ It is easy to see how the existence of a variety of different approaches allows creative lawyers to pursue claims against secondary actors who otherwise might not have been sued at all. This is not to say that expanding private securities litigation is inherently bad, as some would argue; securities litigation can serve a legitimate purpose, especially from the perspective of an investor like Buddy Schwartz.¹⁹⁶ It provides defrauded investors with a remedy that might not otherwise be available, despite the SOX Fair Funds provision. Legitimate securities litigation also serves to increase the goals of market transparency and honesty by preventing economic disasters from repeating themselves.¹⁹⁷

However, the objectives of securities law—honesty, fairness, disclosure, predictability, certainty, and economic efficiency—would be better served if Congress were to adopt a single, unitary standard for secondary actor liability that would apply equally to all Rule 10b-5 claims. This would eliminate the ability of creative lawyers to continually expand the frontier of securities litigation by seeking loopholes in precedent. Certainty and predictability would be the hallmarks of such a unitary standard, and national uniformity would increase economic efficiency because firms would know which standard applies without worrying about the effects their operations

195. See Lisa H. Nicholson, *A Hobson's Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 101–03 (2002) (discussing how the current state of Rule 10b-5 liability allows securities lawyers to be sued for not disclosing their clients' fraudulent misrepresentations).

196. Compare Rose, *supra* note 33, at 1363–64 (suggesting it is time to do away with private securities litigation), with Brown, *supra* note 40, at 15 (promoting the benefits of private securities litigation).

197. See Brown, *supra* note 40, at 15 (suggesting that failing to allow adequate private securities litigation will lead to a repeat of events such as the stock market crash of 1929).

in different jurisdictions have on their securities liability or worrying about the possibility of forum shopping.

B. A Unitary Statutory Standard That Properly Protects Investors

Any proposed standard must be broad enough to encompass both misrepresentation and scheme-to-defraud Rule 10b-5 claims. It must also remain true to the spirit and goals of § 10(b) by promoting fairness and disclosure. The standard also must be specific enough to avoid the ambiguities that hinder many of the existing tests while requiring enough detail to survive a motion to dismiss under the PSLRA. This Note offers a unitary statutory standard that attempts to emulate the positive aspects of the existing tests while avoiding their weaknesses. To this end, this Note suggests that Congress enact a statute that would acknowledge the judicially created private right of action while clarifying secondary liability for both the SEC and the courts. A sample of such a statute is as follows:

Proposed 15 U.S.C. § 78(j)(c).

A secondary actor is primarily liable for violating this section if he or she knowingly or recklessly engages in any activity that has the effect of misrepresenting or omitting the material information available to investors, or otherwise misleads investors through a false appearance of fact, whether or not the actor is personally identified as engaging in the activity. This standard includes a rebuttable presumption of investor reliance.

The SEC shall have power to enforce this provision. Individual citizens also have a private right of action under this provision.

This standard achieves multiple goals. First, by including a scienter element similar to that in the *Anixter* Test,¹⁹⁸ it ensures that the only secondary actors held liable are those who know or should have known that they were engaging in proscribed activity. This protects the truly innocent actors like the *Simpson* vendors who did not realize that AOL Time Warner was using their transactions to “cook the books.”¹⁹⁹ On the other hand, in Buddy Schwartz’s case, Buddy would be able to recover because Merrill Lynch should have known that its transactions with Enron were proscribed.

Next, this standard shifts the focus of the analysis away from the ambiguous concepts that plague the Creator and Bright Line

198. The scienter requirement for “knowingly or recklessly engag[ing] in an activity” is aimed at those situations where the actor knew, or should have known, that their actions would lead to a misrepresentation to investors. See *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996).

199. *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1043–44 (9th Cir. 2006) (explaining how alleged “triangular transactions” were conducted).

Tests, such as whether the defendant “made” or “created” a misrepresentation, and toward the actual effect of the activity. Regardless of whether the secondary actor made or created a misrepresentation or merely participated in activity he knew (or should have known) would have the effect of misleading investors, he is liable. This aspect is particularly helpful to investors like Schwartz, who thus far have been under-protected by existing approaches. Focusing on the effect of the underlying activity also comports with the Supreme Court’s continued adherence to a reliance requirement.²⁰⁰ Although the *Regents of the University of California* court held that Merrill Lynch and others did not owe Schwartz and the other plaintiffs a duty and did not find the defendants liable, in a similar case under this new standard, liability would exist because Merrill Lynch should have known that the sham transactions would mislead investors into believing Enron was in a better financial position than it really was.

This standard also gives deference to the SEC. While several Notes have advocated modifying the Creator Test as a starting point to give deference to the SEC,²⁰¹ this Note suggests incorporating SEC deference in a different manner. This standard utilizes the SEC’s definition of a “deceptive act” as declared in *Simpson v. AOL Time Warner*. However, this standard removes the “principal purpose” requirement and only requires a showing of a false appearance of fact to establish a deceptive act; this would overcome the narrowness of the Principal Purpose Test.

The proposed standard rejects the safe harbor inherent in the Bright Line Test, clearly holding actors liable whether or not they are identified with the fraudulent activity. This avoids the problem with the Bright Line Test that arises when actors flout the law by avoiding attribution. Without an attribution requirement, the standard is broadened to properly reach any actor who behaves contrary to the principles of fair and full disclosure.

Finally, this standard incorporates investor reliance through a rebuttable presumption. Similar to the fraud-on-the-market presumption of reliance announced in *Basic*, this standard balances

200. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) (describing reliance as an essential element of a § 10(b) cause of action).

201. See Caskey, *supra* note 66, at 449 (proposing modifying the Creator Test by including a knowledge requirement and clarifying what it means to “create” a statement); Kimberly Brame, Comment, *Beyond Misrepresentations: Defining Primary and Secondary Liability Under Subsections (a) and (c) of Rule 10b-5*, 67 LA. L. REV. 935, 954 (2007) (praising the Creator Test for its “positive approach to behavioral economics and the law” but criticizing it as overly broad and ambiguous).

the need to protect investors from fraud against the need to prevent meritless suits. Under this approach, once a plaintiff has met the burden of showing that a secondary actor has knowingly engaged in activity leading to material misrepresentations or a false appearance of fact, the burden shifts to the secondary actor to show that the plaintiff did not rely on the secondary actor's actions. While this burden-shifting technique may be criticized as giving too great an advantage to plaintiffs, it is important to remember that this standard's inherent requirement of showing scienter is onerous on plaintiffs in the first instance. Further, this burden shifting is analogous to the technique the Supreme Court used in *Basic* and approved in *Stoneridge Investment Partners*.²⁰² While the Supreme Court hesitated to expand a presumption of reliance beyond two specific situations,²⁰³ the promulgation of such a mandate by Congress would eliminate the need for the Supreme Court continually to redefine the boundaries of where presumptions of reliance apply.

Beyond the specific provisions of Proposed 15 U.S.C. § 78(j)(c), its major strength lies in its ability to blend the various standards of secondary actor liability under Rule 10b-5 into a cohesive, uniform application. This would significantly reduce litigation costs aimed at finding creative solutions to divergent standards, which in turn would increase judicial economic efficiency as fewer court resources are wasted. Certainty and predictability would also be increased because there would only be one standard, regardless of which circuit has jurisdiction, thereby preventing forum shopping. This better conforms to the notion of uniform regulation originally envisioned by Congress.²⁰⁴

This standard also promotes full and fair disclosure, leading to more transparency and honesty in the market. The standard is broad enough to reach any actor involved in fraudulent activity, but is tailored enough to prevent meritless suits because of the interplay between the scienter element of Proposed 15 U.S.C. § 78(j)(c) on the one hand and the heightened pleading standards of the PSLRA on the other. Through its focus on the effects of activity rather than the semantics of "make" versus "create," the proposed addition allows secondary actors to better appreciate whether their particular actions

202. The Court in *Stoneridge Investment Partners* also described a presumption of reliance where an actor with a duty to disclose omits a material fact. 128 S. Ct. at 769.

203. The two specific situations are the fraud on the market theory and the duty to disclose theory. *Id.*

204. The Constitution grants authority to Congress to impose uniform regulation on Interstate Commerce (including the securities markets), U.S. CONST. art. I, § 8, cl. 3, which Congress in turn delegates to the SEC, Securities Exchange Act of 1934, 15 U.S.C. § 78(d) (2000).

are likely to create liability for them. At the same time, it encourages secondary actors to pursue only those activities that will lead to more honesty in the market.

Notwithstanding that this standard is aggressive and may be criticized as promoting over-deterrence, inconsistent with recent Supreme Court jurisprudence, this proposal presents a solution that protects investors and comports with the spirit of § 10(b). For instance, the *Stoneridge* Court declined to find liability where the defendant vendors were engaging in unusual transactions with Charter, which used the transactions to inflate its revenues, because the transactions were too tenuous to support reliance and causation.²⁰⁵ Under this Note's proposal, reliance is presumed, which seemingly overlooks the Court's requirement that reliance and causation be connected. However, Proposed 15 U.S.C. § 78(j)(c) addresses this issue in a different way. Under this proposed standard, an actor must either knowingly or recklessly engage in the activity with the result that investors are misled. The knowledge or recklessness requirement of the standard ensures that reliance and causation are connected, because if a plaintiff cannot prove knowledge or recklessness, the claim will fail. As a result, the focus will properly shift from the actions of the victim to those of the secondary actor. Applying the proposed standard to the facts of *Stoneridge*, it is reasonable to assume that the defendant vendors should know that their transactions with Charter would result in Charter "cooking the books" and, in turn, that investors would be misled. Similarly, applying the standard to the Schwartz case, Merrill Lynch would be found liable because the firm not only helped Enron "cook the books," but it also employed financial advisors who suggested to many clients including Schwartz that they should purchase Enron stock. This is a clear example of a case in which the defendant should have known that its activities would mislead investors, and thus, its behavior was reckless. This standard thus addresses the reliance and causation connection concerns of the *Stoneridge* Court, and it does so in a manner that is more likely to lead to favorable results for defrauded plaintiffs.

Another potential criticism of the proposed statute is that a private right of action is unnecessary in light of the Fair Funds provision of SOX that allows the SEC to distribute disgorged profits from violators to the victims. Although Fair Funds could be very beneficial to defrauded investors like Buddy Schwartz, this provision has been criticized as being "limited in several different ways that will, in a good many instances, prevent it from providing total

205. *Stoneridge*, 128 S. Ct. at 769.

restitution to investors harmed as consequence of a violation.”²⁰⁶ The Fair Funds provision is especially limited in the secondary actor context because “no part of the civil fine imposed upon co-violators, who avoided disgorgement because they did not benefit from their misconduct, would be made available to their victims.”²⁰⁷ Thus, some form of a private right of action, as advocated in this Note, must remain viable.

Proposed 15 U.S.C. § 78(j)(c) would solve many of the problems currently associated with Rule 10b-5 litigation while avoiding the problems of ambiguity and safe harbors. The standard also comports with the various policy goals advocated by Congress, the SEC, and the Supreme Court. While advancing these goals, this standard better protects investors like Schwartz.

V. CONCLUSION

The *Central Bank* decision has caused a great deal of confusion and disagreement, simultaneously simplified and complicated by *Stoneridge*, over the proper standard for secondary actor liability under Rule 10b-5. This Note proposes a new statutory standard that complies with the *Central Bank* distinction between primary and secondary liability while remaining faithful to the goals of securities laws. Meeting these goals is essential for the future of the securities markets.

Unfortunately, the conflict over the proper scope of secondary actor liability has not been without its casualties. It has been said that “[t]he only ones who profit in the end are the lawyers.”²⁰⁸ While this may be true, the sad reality is that many innocent, hard-working investors like Schwartz are the ones who ultimately pay the price. Current securities law jurisprudence has failed to preserve the honesty and fairness of the market when a man like Schwartz can lose his entire retirement without recourse against one of the primary participants in the fraudulent scheme that deprived him of much of his savings. Often courts have been too focused on the forest to notice the trees.

This proposal, while not retroactively restoring Schwartz’s retirement, will help to ensure the financial security of millions of other hard-working Americans by providing a remedy in addition to

206. Cox & Thomas, *supra* note 158, at 742.

207. *Id.* at 754.

208. Brown, *supra* note 40, at 15 (quoting *Bankers Ethics*, WALL ST. J., June 16, 2005, at A16).

that provided by Fair Funds under SOX. In the unfortunate event that a fraudulent scheme or misrepresentation deprives innocent employees like Schwartz of their savings, the unitary standard promises to help them regain some of their financial losses from any actor who defrauded them and should have known better. This safety net is essential to achieve fair and honest markets for everyone. That is the essence of the American Dream.

*Robert John Grubb II**

* Candidate for Doctor of Jurisprudence, May 2009, Vanderbilt University Law School. I would like to thank: Professors Amanda Rose and Gary Brown for their invaluable wisdom and input; the VANDERBILT LAW REVIEW staff for their hard work, especially Ben Schrader for his diligent editing efforts and patience; the Notes Committee for allowing me this opportunity; and my Mom for her continued support and willingness to read draft after draft.